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Switching on to economic success?

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Editor's note

Identifying the best route to economic success – past and future – is one of the themes linking several pieces in this issue. As our front cover hints, it may be more than just a matter of finding the right switch to press. The approaching millennium has focused economists' minds too, as has the first anniversary of the new Labour government in Britain. The Centre for Economic Performance has always concentrated on the big issues: this summer CentrePiece reflects some of the current work examining the changing economic landscape.

One of the biggest changes in recent years has been the spread of job insecurity: even people who have no experience of unemployment are worried about their working future as politicians and business leaders talk about the end of the job for life. Paul Gregg and Jonathan Wadsworth have been looking at whether this perception is borne out by the facts: the first results of their new research – you saw it here first – suggest that the picture is more complicated than the mantra might imply.

It's currently fashionable in political circles to talk about the third way. Alan Manning offers a controversial contribution to the debate by asking whether this third way really exists. He warns of the danger of overlooking policies of proven effectiveness in the quest for a new economic policy. For some European countries, any economic policy will feature the single European currency from next January. Continuing our analysis of the effects of EMU, Hélène Rey considers what role the euro will have in the international monetary system – and, in particular, whether it will pose a challenge to the dollar's supremacy.

Big ideas do not come much bigger than ensuring the survival of the planet and in our first, and long overdue, article on environmental economics, Daniel Sturm looks at last December's Kyoto deal: he argues that the controversial agreement on emissions trading could be a valuable tool for controlling global warming. Danny Quah, of course, always thinks big and as he returns to his regular column he suggests that society should embrace the inevitable change which weightlessness will bring.

Most of the articles in this issue look forward: but this is also an appropriate time for reflection. Standing back from the political disputes, Nicholas Crafts gives his end of term report on the Conservative class of 1979 to 1997, offering a measured economic assessment. This makes a neat juxtaposition with our distinguished guest columnist: Ed Balls, Chancellor Gordon Brown's Economic Adviser, sets out his views on developing an effective economic policy for the future. And Graham Ingham neatly brings all this talk of change together in his assessment of the implications of globalisation for governments.

Mark Bennister

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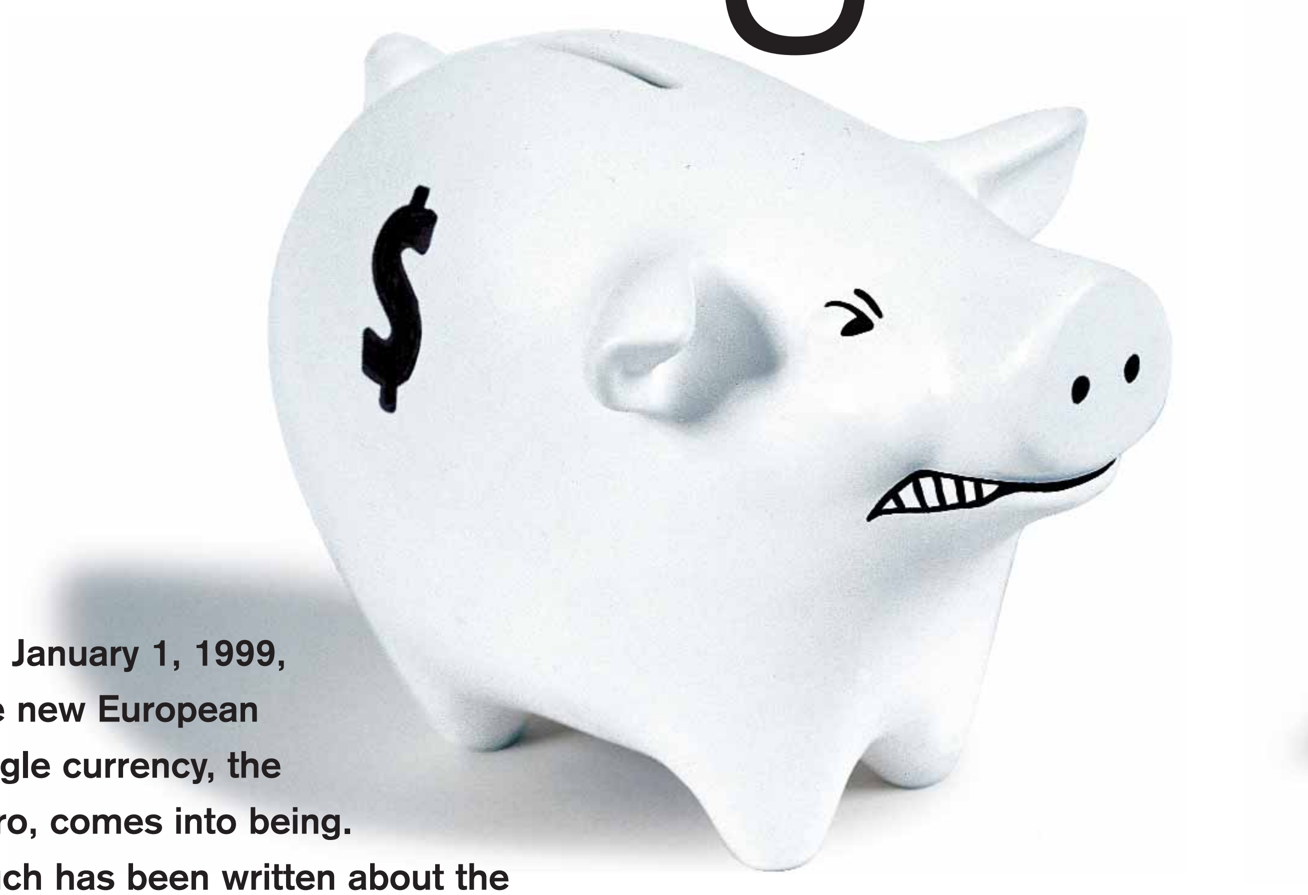
Gearing up for a fight:



On January 1, 1999, the new European single currency, the euro, comes into being. Much has been written about the internal operation of monetary union; but here, Hélène Rey of the CEP, considers a different aspect: what role the new currency will have in the international monetary system.

After half a century of domination in world monetary affairs, the dollar is about to face its stiffest challenge: from a new currency which does not yet even exist. So far, at any rate, American policymakers have tended to be sceptical about the seriousness of any threat to the dollar; and most consumers on both sides of the Atlantic probably don't care. Ordinary Europeans, indeed, are mainly pre-occupied with the difficulties of getting used to a new currency. But some European politicians and economists (especially in France) by Hélène Rey

the euro, the dollar and the international monetary system

see economic and monetary union (EMU) as the best hope of undermining the dollar's hegemony in the international monetary system. Are they right? And does it matter anyway?

Up for grabs?

It certainly matters. You don't have to be an economic historian to realise that international monetary supremacy confers substantial political benefits. Just look at America's postwar experience. The hegemonic power is always better insulated from outside influence or coercion in formulating and implementing policy. It is also able to pursue its foreign objectives with fewer constraints – as well as to exercise a considerable degree of influence over others. Examples abound: the unilateral decision by President Nixon in 1971 to abandon the postwar monetary system and more recently, the crucial role played by the US Treasury in the Mexican debt crisis of 1995.

There are economic gains, too. The issuer of an international currency – that is, a currency held in large quantities by foreigners – can benefit from *seigniorage* gains (essentially, the profit which governments make by printing money). Conventional estimates indicate that as much as 50 to 60% of the total US outstanding money stock is held abroad (the black economy accounts for a lot of these money holdings). The flow of international seigniorage to the United States is around 0.1% of US GDP per year. And there is another, often neglected, source of

A shift in the balance of power in the international monetary system could mean political and economic gains for Europe – at the expense of the US.

seigniorage: a liquidity discount on short-term government debt. The dollar's status as international currency and the consequent demand for it, has the effect of reducing the real yields that the US government has to pay on its debt. Non-resident holdings of US government securities make up about 25% of the total stock, compared with 17% of other government debt. Rough estimates indicate that this second source of seigniorage could amount to another 0.1% of US GDP. Efficiency gains from the extensive use of a currency could be as much again as seigniorage gains.

None of these numbers are huge – but nor are they negligible. So a shift in the balance of power in the international monetary system could mean political and economic gains for Europe – at the expense of the US. But how likely is a shift – and if there is one how significant will it be? Richard Portes (of the LBS and CEPR) and I have developed a new analytical approach to try to answer these questions.

Until now, international trade flows and official reserve holdings have been seen as the main determinants of international currency use and the main way of predicting changes. It was not until after the Second World War that the dollar replaced sterling as the main international currency – long after the shift in relative economic power between Britain and the US. But in those days, capital was much less mobile than it is today. International financial markets are increasingly inter-connected and integrated: more than one trillion dollars crosses the exchanges every day. It seems reasonable to assume that changes could occur much more quickly nowadays. In our analysis, therefore, financial market considerations take centre stage.

Figure 1 Two-way foreign exchange market transactions

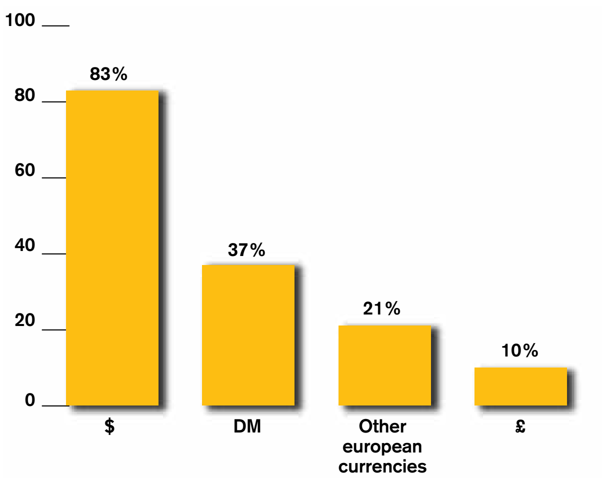


Figure 2 World exports

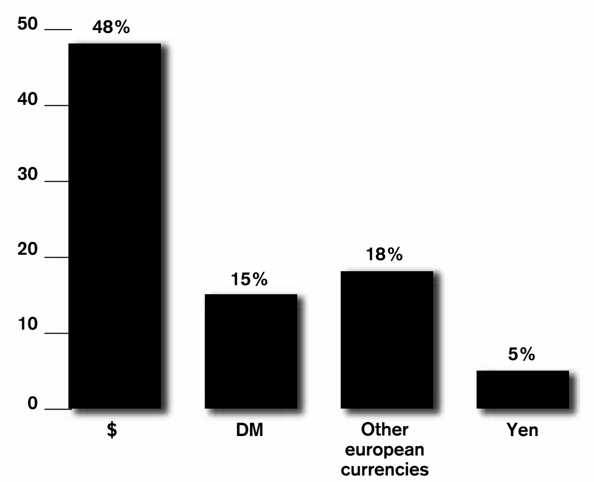
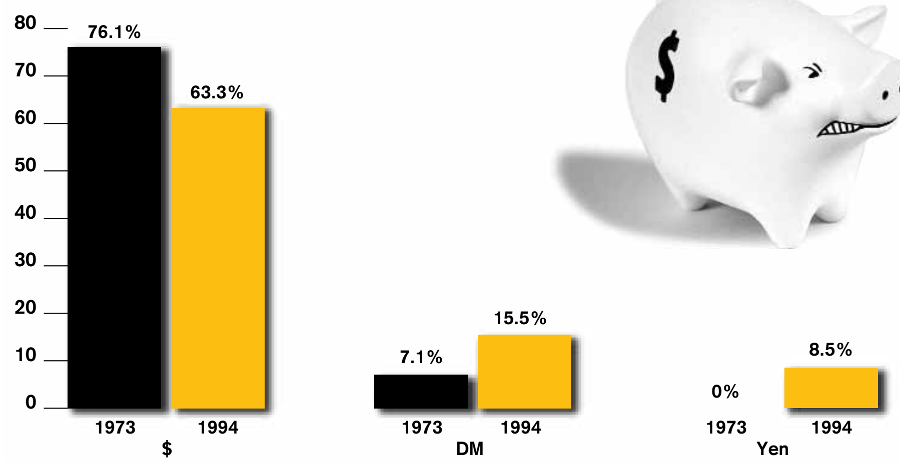


Figure 3 Official reserves



Source: *The Emergence of the Euro as an International Currency*, Alogoskoufis, Portes and Rey, Discussion Paper 388, May 1998.

The share of the dollar in official reserves, although declining, is overwhelmingly higher than the share of any other currency. With the creation of the euro, however, all this could change.

The expanding euro?

What gives a currency international status? A currency is a good means of payment if a lot of people use it. The usefulness of any given currency for financial transactions and for the denomination of financial assets increases in line with the number of people using it. When markets are very liquid (or easy to use), transaction costs are low and this, in turn, encourages even more people to use them, an effect known as a *network externality*. For this reason, the financial markets using the euro will potentially be much bigger than all the financial markets in EMU member countries added together. Moreover, as the euro-denominated securities markets grow and become more liquid – with the consequent fall in transaction costs for people using those markets – euro-denominated assets will become even more attractive.

That in turn will expand the use of the euro as a *vehicle currency*, that is a currency used as an intermediate stage in the exchange of two currencies (usually with limited circulation) which cannot be exchanged directly. There is an obvious synergy between the use of a currency as a vehicle in this way and as a currency of denomination for financial assets.

In our analysis, the currency in which private invoices are denominated, the currencies held as central bank and government reserves and the use of a currency as an anchor or peg in international exchange rate systems are all secondary to these financial and foreign exchange market interactions.

For now the dollar is king

Currently, of course, the dollar is the dominant international currency however you choose to measure it. Figure 1 shows the denomination of foreign exchange transactions: the dollar is used in 83% of two-way transactions, with the next most frequently-traded currency, the deutschemark only used in 37% of such transactions. Figure 2 shows a similar picture for the invoicing of world exports. Figure 3 shows that in spite of a decline in the dollar's share of official reserves, its position remains dominant. The domestic market in Europe for private bonds is two-thirds of the American market; total public sector debt in the European Union countries amounts to two-thirds of that in the US. The share of the dollar in official reserves, although declining, is overwhelmingly higher than the share of any other currency. With the creation of the euro, however, all this could change.

A glimpse of the future

The euro will come into being on 1 January 1999 with eleven members*. In due course, though, the euro area is likely to include all fifteen existing members of the EU, including the UK, whose membership will be significant because of the size of London's financial markets. It will probably take much longer to integrate the countries of eastern and central Europe expected to join the EU after 2002. It's fair to assume that the new European Central Bank (ECB) will act quickly after next January to establish its credibility and reputation in the world's financial markets.

We have constructed a three-region model of the world (Europe, United States, Asia) to see how the choice of a vehicle currency is likely to be determined from 1999 onwards and to gauge the demand for financial assets denominated in different currencies over the medium term. This model suggests that several different outcomes are possible.

We've called the first scenario the *quasi status quo*. Here, the euro replaces the dollar as the dominant currency for exchanges between Europe and the Asian bloc, but the dollar remains the vehicle currency on the foreign exchange markets. In our second scenario, the *medium euro*, the new currency replaces the dollar as the main international currency for financial asset transactions; but transactions between the United States and the Asian bloc are still dominated by the dollar, and the dollar is still the vehicle currency on the foreign exchange markets. In our *big euro* scenario, the euro also takes on the role of vehicle currency.

Foreign exchange and securities market data show that the first of these scenarios is most likely in the short term. But if financial market integration in Europe progresses sufficiently, then the overall size of the European securities markets could bring transaction costs down to the point where the fundamentals would support either the *medium euro* or the *big euro* scenario. The euro may then begin to usurp some of the dollar's international roles, although the extent to which it does this will depend on policy decisions and on the beliefs of market participants.

The analysis suggests that if displacement on a large scale did occur there would be quantitatively significant potential benefits for the euro area. These could be similar in size to the international seigniorage benefits currently enjoyed by the US – and the gains would be partly at the expense of the US and, to a lesser extent, of the Asian bloc. Adding together seigniorage and efficiency gains, we reckon that in an extreme case, if the euro were to replace the dollar almost entirely – the big euro scenario – the benefits to the euro economies could be somewhere in the region of 0.3% to 0.5% of GDP.

A mixed blessing?

On the face of it, these figures provide strong support for political leaders keen to promote a significant international role for the euro. But there are arguments which weigh against such an approach – and which have in the past led both the Bundesbank and the Bank of Japan to discourage the greater international use of their currencies. Being the world lender of last resort can be a curse rather than a

* Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

An opaque Central Bank reluctant to explain its monetary policy decisions would be more likely to become a scapegoat for European public opinion if the euro area were to experience a serious economic downturn in the future.

blessing, as successive American administrations have discovered. Material gains as well as policy autonomy can be eroded by the accumulation of an overhang of liquid foreign liabilities, something British governments realised in the 1960s and 1970s. Policy can become increasingly constrained by the need to discourage sudden conversions into other currencies.

But if the balance is nevertheless judged to favour the internationalisation of the euro, policymakers should focus their efforts on integrating European capital markets: increasing their liquidity, breadth, and depth. For this, both regulatory policy and various aspects of harmonisation across Europe would be crucial; so too will private market initiatives (establishing benchmark interest rates and securities). Any measure which enhanced the credibility of the European Central Bank would also be important (though the new central bankers should bear in mind that credibility does not always mean engaging in tough monetary policy).

More than anything, the ECB in its early days needs to develop its own distinct identity. The board needs to function in a way which eliminates the suspicion of national coalitions. The battle between M. Trichet and Mr Duisenberg to become the ECB's first President has been counterproductive by shifting the debate from ability to competing nationalities. Ensuring proper accountability for the ECB is also important, to ensure long run political support for the common currency. An opaque Central Bank reluctant to explain its monetary policy decisions would be more likely to become a scapegoat for European public opinion if the euro area were to experience a serious economic downturn in the future. This could help strengthen the anti-European sentiment still prevalent in some EU members.

Potential instability

Whatever happens in the long run, the dollar is certain to remain quantitatively dominant for some considerable time. The speed of change in the global economy may be far greater than in even the recent past: but lags are inevitable, as are uncertainty and simple inertia. Indeed, the early years of monetary union could see considerable instability associated with the emergence of the euro on the international scene. The European authorities will have to take account of this potential instability and the inevitable exchange-rate pressures in setting monetary policy. This may make simple policy rules (like targeting monetary aggregates) inadvisable, at least in the early years.

At the same time, improvements in international macroeconomic policy co-ordination may be needed to mitigate the effects of potentially sizeable portfolio shifts. Smoothing out the decision-making process within the euro area itself would be a good place to start. In particular, the respective powers of the ECB and the various EU ministerial and official committees will have to be clarified. This is unlikely to happen until monetary union is up and running, and even then may take some time judging by some of the recent quarrels that have plagued Ministerial discussions. All EU members, whether in EMU or not, will continue to participate in discussions at ECOFIN (the regular meeting of finance ministers), and some of these discussions will involve matters relating to the work of the ECB. But a new, quasi-informal group of ministers has also been created, Euro-11: membership of this group, which has been set up to keep an eye on how EMU operates, is restricted to the 'ins'.

Other outstanding issues which remain to be solved include the lender of last resort function of the ECB, as well as the nature of its role in supervising and regulating the banking system. The EU also has to tackle the contentious issue of *subsidiarity* – how in the future should EU countries co-ordinate their positions in international fora: should the G7 become a G3, for example, or should the EU become a single member of the IMF? These are all difficult issues and some at least will be the subject of acrimonious debate. They are likely to ensure that whatever happens in the financial markets to erode the dollar's supremacy once the euro comes into being, the *political* benefits of having an international currency will elude the EU for some time.

Hélène Rey is a member of the CEP's National Economic Performance Programme.

The Emergence of the Euro as an International Currency, Alogoskoufis, Portes and Rey, Discussion Paper 388, May 1998 is available from the Centre for Economic Performance, price £5.

Whatever happens in the financial markets to erode the dollar's supremacy once the euro comes into being, the political benefits of having an international currency will elude the EU for some time.

by Paul Gregg and Jonathan Wadsworth

End of the job for life?

The CEP has long been known for its groundbreaking work on the operation of labour markets. Here Paul Gregg and Jonathan Wadsworth report on new research which has been testing the contention that job insecurity in Britain is much greater than it used to be.

If there is one thing the average Briton shares with most media commentators these days, it's the certainty that the job for life is a thing of the past. The conviction that job insecurity is far worse than ten or twenty years ago is widespread. Yet some observers see this as a classic example of public perceptions being out of line with the facts: they note, for instance, that most of the available data appears to show little actual change in patterns of job stability. This is an area where perceptions are particularly important – if people feel insecure about their jobs, it can have a significant impact not just on factors such as work morale, but on the overall quality of life. The true extent of job insecurity also has important implications for government policies in this area. So trying to pin down who's right in this debate is a worthwhile, if difficult, exercise.

Job security is a difficult concept to measure. But we can find a useful proxy in a related concept which is easier to assess: how long a job is likely to last and whether this changes over a set time period. Our research has used both of the major data sources available, that contain information on job stability in the UK, to try to get at the facts. As is so often the case, we discovered a much more confused picture than the debate might suggest. Job stability does appear to be declining for most of us. But the general ageing of the population (as people live longer, and have fewer children the average age of the population rises) coupled with a significant shift in the employment patterns of women who've had children, has tended to mask these underlying trends. There's an important qualification to be made, however: the scale of the changes taking place are relatively small – it is not at all clear that they are substantial enough to justify public perceptions.

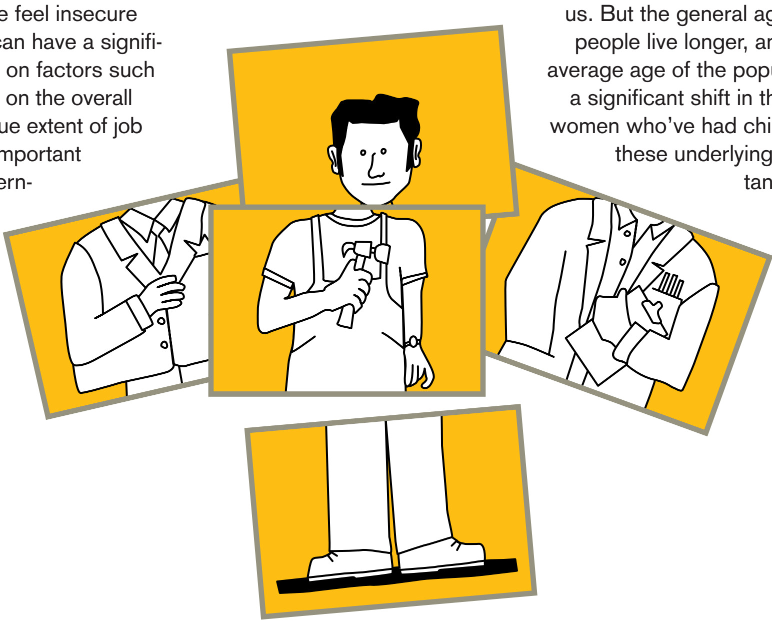


Table 1 Separation rates by job tenure

Length of current job	Total 1992	Total 1997	Men 1992	Men 1997	Women 1992	Women 1997
Months						
1 month	20.5	24.9	20.4	23.8	20.6	26.4
2 months	22.2	21.8	23.9	21.3	20.7	22.4
3 months	16.9	18.8	16.7	18.8	17.2	18.8
4 months	15.8	15.3	15.1	17.7	16.5	12.8
5 months	16.5	15.2	18.2	15.4	15.0	15.0
6 months	14.6	14.8	13.8	13.7	15.2	15.9
12 months	8.7	9.2	6.8	9.5	10.5	8.8
Years						
1-2 years	7.8	8.0	6.9	7.7	8.5	8.2
2-3 years	5.8	5.9	5.9	5.6	5.7	6.2
3-4 years	4.4	4.6	4.7	4.5	4.2	4.6
4-5 years	3.5	4.0	3.2	3.5	3.9	4.5
9-10 years	1.9	2.6	1.4	1.8	2.7	3.5
14-15 years	1.8	0.7	2.0	0.8	1.5	0.6
20 years+	2.4	1.8	2.9	1.3	1.4	2.9
Total	5.5	5.9	4.9	5.6	6.1	6.3

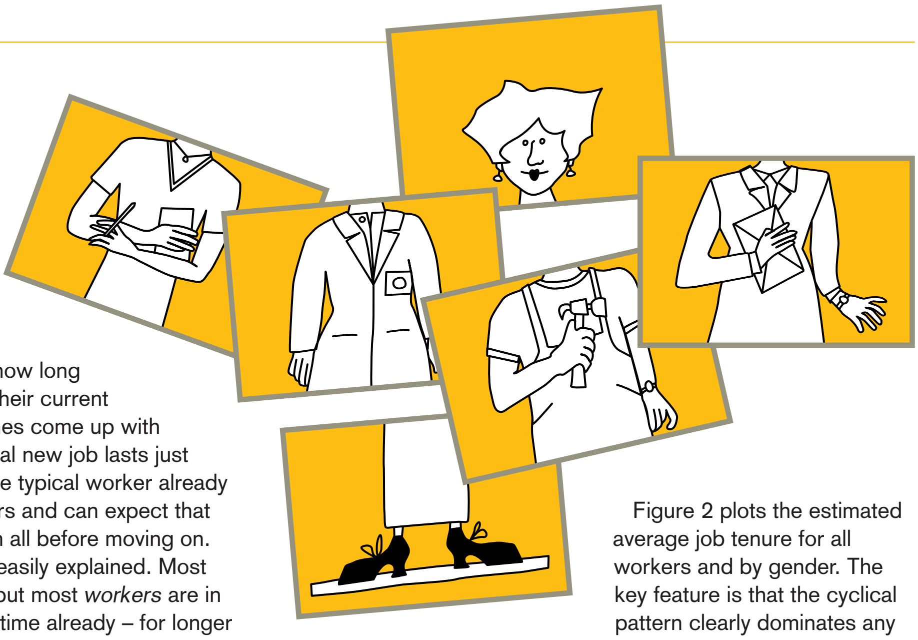
Source: Labour Force Survey

Table 2 Median job tenure by age

	Age 16-24	25-34	35-49	50+	Total
Total					
1985	1yr 7mo	4yr 6mo	7yr 8mo	13yr 1mo	5yr 2mo
1995	1yr 5mo	4yr 4mo	7yr 4mo	10yr 7mo	5yr 6mo
% change 85-95	-10.5	-3.7	-4.3	-19.1	-9.6
Men					
1985	1yr 8mo	5yr 5mo	10yr 1mo	15yr 10mo	6yr 8mo
1995	1yr 6mo	4yr 11mo	9yr 2mo	12yr 10mo	6yr 6mo
% change 85-95	-10	-9.2	-9.1	-18.9	-3.7
Women					
1985	1yr 5mo	3yr 3mo	5yr 1mo	10yr 1mo	3yr 11mo
1995	1yr 5mo	3yr 8mo	5yr 7mo	9yr	4yr 7mo
% change 85-95	0	12.8	9.8	-10.7	17
Women with dependent children					
1985	0yr 11mo	1yr 11mo	4yr 2mo	7yr 11mo	2yr 8mo
1995	1yr	3yr 1mo	4yr 7mo	7yr 1mo	3yr 9mo
% change 85-95	9.1	60.9	10	-10.5	40.6
Women without children					
1985	1yr 10mo	4yr 10mo	7yr 11mo	10yr 8mo	5yr 1mo
1995	1yr 7mo	4yr 2mo	7yr 6mo	9yr 3mo	5yr 5mo
% chnage 85-95	-13.6	-13.8	-5.3	-13.3	6.6

Source: Labour Force Survey

Job Stability in Britain



The first challenge an analysis of this kind has to face is how to measure job stability? One way is to look at new jobs and see how long they survive. An alternative approach is to ask how long those in work have been with their current employer. These two approaches come up with very different results. The typical new job lasts just 15 months, for instance; but the typical worker already has a job that has lasted 5 years and can expect that job to last for about 10 years in all before moving on. This apparent contradiction is easily explained. Most *jobs* last for only a short time, but most *workers* are in jobs that have lasted for some time already – for longer than the average job duration, in other words – and the longer a job has already lasted, the longer it is likely to last in the future.

Figure 1 takes a cohort of new jobs (those created between December 1991 and February 1992) and then every three months asks how many of the jobs are still in existence. By the summer of 1993, 15 months on from the start of the exercise, half of those new jobs have already disappeared. After two years, only a third of the new jobs are left. But significantly, after 5 years a fifth are still there. So the rate at which jobs disappear falls sharply over time. Table 1 gives the proportion of workers who leave their jobs each quarter, measuring how many months and years these jobs had lasted. For the first few months of a new job, about one worker in five will leave their job (for whatever reason) each quarter. But by the end of the first year of a job, that figure has fallen to one worker in ten; after 3 years, only 5% of workers will leave their jobs, and only 2% will do so after 10 years.

All this means is that someone taking a new job can on average expect to stay in it for only 15 months; but that those who have stayed in a job for 2 years will, on average, stay with it for another 3 years; and those jobs which have already lasted 3 years will on average last for 7 years in all. So although most new jobs have short lifespans, most people in the current workforce are in jobs which have lasted beyond the critical initial phase when those new jobs tend to disappear. In fact, the typical member of the labour force is in a job which has already lasted for 5 years, and can expect that job to last for as long again, with the typical job lasting just over 10 years in all.

But how have things changed?

But this picture is essentially a snapshot of job tenure today. It does not tell us much about whether patterns of tenure have changed over time. By using data from the Labour Force and General Household Surveys we can analyse changes in job stability over the last 20 years.

Figure 2 plots the estimated average job tenure for all workers and by gender. The key feature is that the cyclical pattern clearly dominates any trend – the overall state of the economy is crucial in determining the average length of time workers stay in a job.

It's perhaps more surprising at first to discover that this cyclical variation in job tenure appears to run against the general economic cycle. Average job tenure rises in recessions and falls in good times. The explanation for this is simple. In a boom, many new jobs are created and so more workers quit their jobs voluntarily – to take other, better paid jobs, for example – and this movement reduces the average length of all jobs. In a recession, there are fewer new jobs and fewer people voluntarily leave the jobs they have, so average tenure rises. It's true that there are more layoffs in a recession, but these tend to be spread fairly evenly across all jobs, and so have little impact on the average life of jobs.

Table 2 compares the typical job tenure in 1985 and 1995, similar points on the economic cycle of new job creation (by measuring vacancies), across age groups and for men and women with and without children. Average job tenure has fallen most for those over fifty and least for those aged between 25 and 34. Job tenure is still higher for older workers, because more of them are in jobs which have survived beyond the initial new job shakeout described earlier; so fewer jobs held by older workers are likely to disappear. So if the average age of the population rises then average job tenure will also rise. More older workers means fewer people leaving their jobs, and thus more surviving jobs. The average age of the population rose by two years between 1985 and 1995, so average job tenure rose as well.

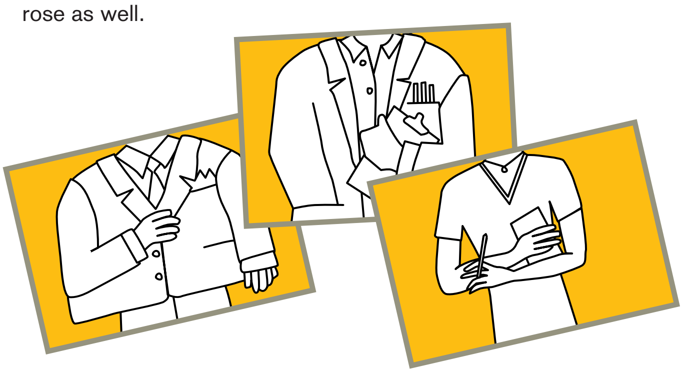
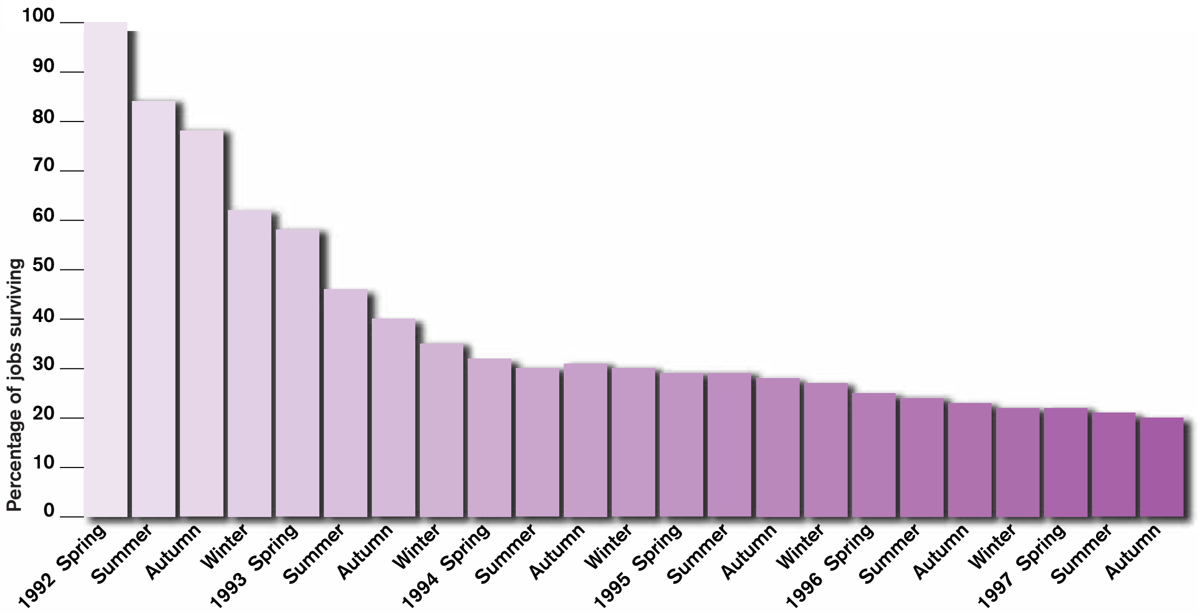
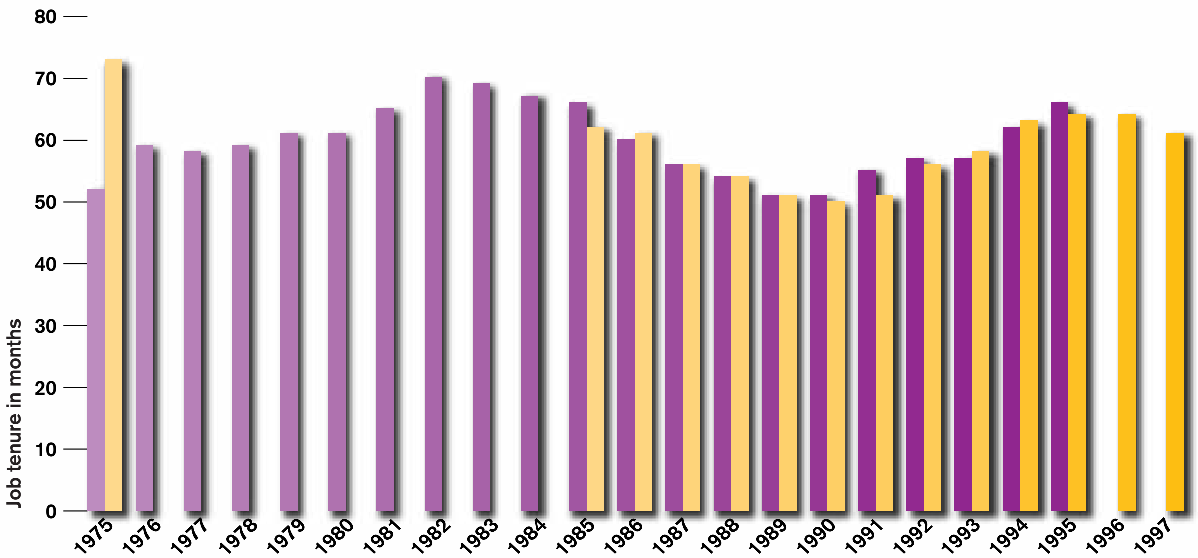


Figure 1 Disappearence of jobs created between December 1991 and February 1992



Source: Labour Force Survey

Figure 2 Median job tenure, 1975-1997, all
■ GHS ■ LFS



Source: Labour Force Survey and General Household Survey

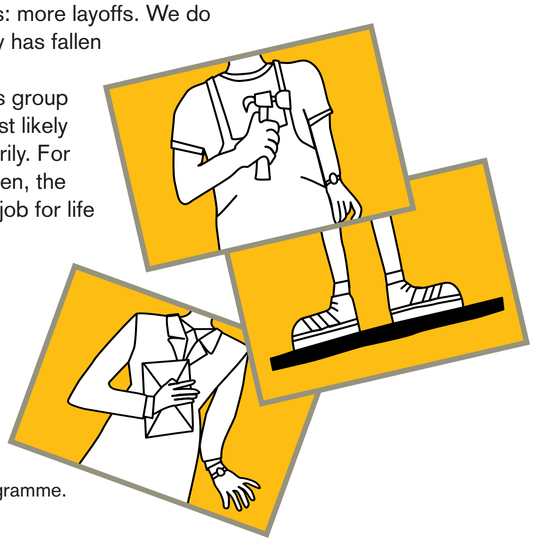
A different picture for different groups

The picture is rather different for specific groups of workers. For men and women without dependent children, job tenure has fallen by around 10% for most age groups. But job tenure amongst women with dependent age children has risen rapidly, primarily amongst those aged between 25 and 34. We believe that this is because the use of maternity leave has increased sharply over the last 20 years. According to research undertaken at the Policy Studies Institute, in 1979 just 18% of women working full-time returned to the same employer after childbirth. This has now risen to 70%. This means that childbirth no longer marks the end of a job – and job tenure – for most women.

These opposing trends, together with an ageing population, mean that overall job tenure has changed little between 1985 and 1995, and statistical analysis has confirmed this pattern. Between 1985 and 1997 the proportion of workers with tenure greater than 10 years fell by 5 percentage points for men and 4 percentage points for women without children; but it rose for women with children. These changes have been concentrated on older workers, but there is surprisingly little evidence to suggest that these changes in job stability are affected by the level of education. At the opposite end of the scale, more jobs now last less than a year – which is in line with the overall picture of a 10% fall in the average life of jobs, apart from those held by women with dependent children.

An uncertain world

When the figures are examined in detail, the nature of the changes becomes clear. Much less clear, though, is whether the size of these changes is large enough to justify the increasing sense of job insecurity now so prevalent. Nor is it clear whether the changes described require specific policy responses from government. There are, moreover, some uncertainties which remain. We do not yet know whether we are observing decisions which are largely voluntary; or whether the changes reflect what the greater public unease implies: more layoffs. We do know that job stability has fallen furthest among older workers, and that this group of workers is that least likely to leave a job voluntarily. For this group at least, then, the end of the belief in a job for life is something whose passing is mourned.



Paul Gregg and **Jonathan Wadsworth** are members of the CEP's Human Resources Programme.

An end of term report

The Conservatives and the British economy

Eighteen years of Conservative government in Britain ended with electoral defeat on an almost unprecedented scale in May 1997. The Thatcher revolution was, above all, an economic one, and the Conservatives left office claiming that the UK economy was in better shape than for more than a generation, a claim hotly disputed by the Tories' critics. So who's right? Nicholas Crafts of the CEP stands back from the political rows to assess the Conservative record.

Even with the benefit of hindsight, separating rhetoric from reality is always difficult when judging economic performance. Almost every economic fact is open to subjective interpretation: unlike their colleagues in the natural sciences, for example, economists can't rerun the experiment to see how things would have turned out in other circumstances; it's difficult to take account of the political constraints imposed on policymakers when analysing the economy; and there's not even any agreement on which economic policy objectives should take precedence over others.

Reaching consensus about what the Conservatives did right and what they did wrong – and even what they had influence on in the first place – is well-nigh impossible, therefore. But it *is* possible to see what happened to the British economy over the eighteen years of Tory rule and to make judgements about the link between the policies which were pursued and the outcome in terms of economic performance. Though difficult, the exercise is worthwhile: not just in terms of understanding the past, but – far more important – because of the guidance it can offer to policymakers now.

1979 and all that

When Mrs Thatcher came to power in 1979, her government explicitly abandoned the consensus approach to economic policy which had prevailed pretty much since the end of the second world war. Keynesianism was repudiated. Full employment and reducing income inequality were dropped as economic targets and were replaced by control of inflation and productivity growth. The government sought actively to remove the trade unions' veto on economic reform. A new emphasis on the supply-side of the economy was meant to address longstanding problems of weak productivity and labour market failure.

These were radical measures, required in the new government's view, by the legacy it had inherited. Britain's economic performance had been declining relative to the other main industrial countries from the 1950s onwards. Attempts to speed economic growth from the 1960s had been marked by failure. Vocational training was poor. Labour was used inefficiently. Bargaining between unions and management had led to overstaffing, while increasing wage militancy was augmented by rising unemployment benefits and rising taxes on labour. Unemployment was inexorably rising.

The short term dominated economic policymaking – and the oil prices shocks of the 1970s, which had led to stagflation both in Britain and other countries, reinforced this. Governments of both main parties were interventionist: they believed rising unemployment spelled electoral disaster, yet they seemed powerless to prevent both this and rising inflation. Mrs Thatcher inherited an economy so weak that disengaging from this approach to macroeconomic policy and putting far more emphasis on the supply side could at best entail short-term pain in return for long-term gain. But long-term gain crucially depended on sustaining radical reforms over a long period. There were no quick fixes.

They promised to fight inflation

Essentially the Tories sought to raise the rate of economic growth while bringing down both inflation and unemployment. In their public pronouncements at least, they started with inflation which remained the central plank of their economic policy throughout the eighteen years. The aim was to move right away from demand management: with the launch of the Medium Term Financial Strategy (MTFS) in 1980, it was clearly signalled that both fiscal and monetary adjustments would respond to inflation rather than unemployment. The immediate implication of the MTFS was a tightening of policy which precipitated a severe recession and a big jump in the exchange rate.

But persistent difficulties in the control and interpretation of monetary targets had led, by 1986, to the adoption of an informal exchange rate target and then, from 1990-1992, to membership of the Exchange Rate Mechanism (ERM) with its explicit commitment to an exchange rate band. Sterling's forced exit from the ERM was followed by the adoption of inflation targets. This was coupled with greater transparency in policy formulation, with the Bank of England publicly monitoring inflationary pressures.

During the first two Thatcher terms, from 1979-87, the reduction in inflation was praised, although the consequences of this process for the real economy were frequently deplored. But as inflation picked up again in 1988, it became clear that two factors had undermined the government's counter-inflationary stance – the persistent failure to choose suitable policy targets combined with a reluctance to surrender political control of either monetary or exchange rate policy.

Neither sterling M3 (£M3), the monetary aggregate chosen in the early eighties, nor a fixed sterling/deutschemark rate make attractive nominal anchors; and for policy, both appear inferior to the inflation targets which were eventually adopted after 1992. £M3 was unsatisfactory because it was hard to control and its relationship to inflation was often difficult to predict. A fixed exchange rate linked to the DM proved doubly unhelpful, partly because the appropriate policy stance differed in Britain and Germany; and partly because using fiscal policy as a stabiliser seemed inconsistent with the government's professed aim of setting taxes using microeconomic or supply-side criteria.

It is indeed difficult to believe that an independent central bank with an inflation target to meet could have presided over the Lawson boom of 1987-88 and the subsequent bust.

It is indeed difficult to believe that an independent central bank with an inflation target to meet could have presided over the Lawson boom of 1987-88 and the subsequent bust. This seems to have been largely an unnecessary and self-inflicted wound: and the contrast in performance at this point with New Zealand where the central bank was made independent with what appear to have been well-designed incentives is striking.

To promote growth...

With the public rhetoric firmly centred on inflation, the government had ruled out attempts to improve the economy's growth performance by stimulating demand. Instead, Mrs Thatcher and her government set out to improve Britain's poor productivity performance. The thrust of policy was to strengthen incentives and market disciplines rather than to subsidise physical investment. Among the key elements of the new supply-side policy were privatisation and deregulation, the reform of industrial relations, the restructuring of taxation and restraint on the growth of public expenditure, a radical revision of vocational training and the expansion of higher education. Foreign direct investment was encouraged; rapid de-industrialisation was accepted in some sectors, and accompanied by a sharp reduction in subsidies to troubled industries.

In broad terms, this re-orientation of policy had theoretical support from modern growth economics; it also remedied earlier mistakes in government economic management in Britain. Both privatisation, accompanied by a regulatory structure which permitted price increases below inflation, and changes in industrial relations, such as the end of the closed shop and reduced worker bargaining power, could be seen as raising managers' incentives to innovate and raise productivity. Cuts in marginal income tax rates and an improved supply of human capital (better trained and educated workers, for instance) can also increase the rewards for innovative effort.

But in this area of policy, too, there were weaknesses in implementation. Some of the potential productivity gains from the privatisation process were foregone because of failures to introduce competition in areas of monopoly supply – with British Gas, for instance; and because the limit on privatised utility price rises – the so-called X factor – was not sufficiently tight. There was also a broader government failure to strengthen anti-trust or competition law.

To reform tax and benefits...

Much was made during the Thatcher years of the government's radical approach to tax cuts and of the importance of reducing the tax burden to promote growth. But here the rhetoric diverged significantly from the reality. It's true that what had been a rapid rise in government spending as a proportion of GDP ceased from the mid-1970s on, and by the 1990s had fallen well behind the big-spending European countries. The very high marginal income tax rates were abolished and VAT was increased in the first Thatcher budget of 1979. But further progress in reducing the burden of taxation was not pursued with great vigour, especially in the 1990s.

It was the same story when it came to benefits. In 1980, the government exhibited considerable courage in ending the indexing of benefits to earnings and linking them instead to prices. By the mid-1990s, this implied a saving of over 3% of GDP, and over £7 billion on pensions alone. But more radical schemes to restructure welfare were regarded as politically too difficult – in spite of clear evidence that benefits like the basic state pension and, especially, child benefit were very badly targeted at the poor. An opportunity to improve provision for the seriously disadvantaged and reduce the burden of taxation at the same time was passed up.

...and cut unemployment

Right from the beginning, the Conservatives eschewed Keynesian responses to unemployment. Perhaps the most famous – and explicit – instance was in the very tight budget of 1981, when 364 economists publicly indicated their disapproval. Policy focused on reducing the NAIRU – the non-accelerating inflation level of unemployment. Initially, the main leverage was sought by reducing taxes on labour, weakening trade unions and promoting the reform of collective bargaining agreements, together with reductions in benefits relative to wages. In the late 1980s, the unemployment benefit regulations were tightened significantly. From 1986, this was all complemented by increased attention to reform of education and training which can be seen as attempting to address structural unemployment by raising the stock of skills in the labour force.

Empirical research using the NAIRU approach has found that high unemployment is associated with generous unemployment benefits which continue indefinitely with little pressure to take work; widespread coverage of collective bargaining with no coordination between employers or unions; high overall taxes; and poor educational standards at the bottom of the labour market. Well-designed interventions along these lines should therefore have reduced equilibrium unemployment.

Given the previous Labour government's experience with its Social Contract with the trade unions, it is not surprising that the Conservatives abandoned incomes policies on taking office, and did not pursue the alternative of seeking to establish greater coordination in wage bargaining. But the complementary approach of trying to hide unemployment by changing the basis on which it was counted, and by encouraging relocation into categories such as disability and youth training, was much less commendable. As is well-known, a fall in the labour force relative to employment raises wage pressure just as much as a rise in employment

You don't have to be an economic historian to realise that international monetary supremacy confers substantial political benefits.

relative to the labour force: so the long-run effect of such measures is to reduce real GDP per person rather than to reduce the unemployment rate.

Progress on productivity

Perhaps the most striking feature of the period was the strong upturn in labour productivity growth in manufacturing. This had only a muted impact on the economy as a whole, however, because it was not accompanied by faster productivity growth in the services sector. The reforms introduced therefore appeared to have their greatest impact on manufacturing, where levels of productivity relative to leading European countries had fallen back spectacularly in the previous 30 years. Indeed, as Table 1 below shows, from 1979 the gap between Britain and other countries closed significantly, with Britain's position in 1995 being generally rather better than in 1973. This was not, however, the case for marketed services, a sector which accounts for a larger share of employment in Britain.

Some of the improvement seems to have followed changes in the bargaining environment and associated developments in industrial relations. Given the prevailing widespread inefficiency of labour use, the recessionary shock of the early 1980s, exacerbated by the ill-judged monetary policy of the time, had a silver lining at least insofar as it precipitated better productivity through the shake-out of labour and the change in bargaining power. But that is not to say that recessions are good for growth: on the contrary, econometric evidence suggests that trend growth in the UK could rise by more than 0.5% a year if the economy were to enjoy greater macroeconomic stability in future.

Studies show that product market deregulation and privatisation both improved productivity growth in Britain over the lifetime of the Conservative government. But the picture on tax and benefits is less clear. There is evidence to suggest that the reduction in average and marginal income tax rates can help explain why growth has slowed in Europe by more than the UK. But this evidence also suggests that the Conservatives' failure to make greater progress in reducing the welfare bill probably had a significant cost in terms of growth foregone.

The Tories also failed to make much impact on Britain's investment performance. The UK remains behind in terms of investment as a share of GDP, although its quality has improved, thanks to the sharp rise in foreign direct investment into Britain and the decline in investment funds going to nationalised industries.

Most difficult to assess, however, is the impact of what were extensive changes in education and training which took place during Conservative rule. Both firms and individuals have invested heavily in training – in real terms, expenditure in this area trebled between 1971 and 1989. The proportion of employees who had had some form of training in the previous four weeks rose from 8.5% in 1984 to 14.4% a decade later. Just under half of 16 year olds stayed on at school in 1986; ten years later this had risen to 71%. The proportion of managers who were graduates more than doubled between 1976 and 1986.

But more hasn't always meant better. There has been much criticism of the reforms of vocational training and of continued deficiencies in the school system, especially for the less able. The rise in the number of vocational qualifications – from 739,000 in 1990-91 to 912,000 in 1994-95 – has been at the lower end of the scale.

Continued on page 32

Table 1 Relative productivity in maufacturing and marketed services
UK = 100 in each year

	1950	1973	1979	1995
Manufacturing				
France	90.4	130.6	149.1	122.1
Japan	45.2	90.5	113.8	104.4
USA	245.7	186.6	179.9	143.5
West Germany	97.5	142.0	163.7	116.8
Marketed services				
France	–	132.3	143.2	136.0
USA	–	156.9	150.3	137.8
West Germany	–	100.6	115.4	133.5

Sources: For manufacturing, Pilat (1996) extended to 1950 and interpolated to 1979 using van Ark (1993) and for services, O'Mahony et al. (1996). Please note that the Pilat figures are comparisons between the other countries and the USA and were originally expressed using the USA as the base country. The final year for the services comparison is 1993 not 1995. Productivity is measured as value-added per hour worked.

The third way?

Alan Manning, of the CEP's industrial programme argues that pressing the right switch for economic success need not mean ditching past policies

Some of the brightest minds in Europe are, it is alleged, looking for the *third way*: the formula that offers improved economic performance in general and labour market performance in particular without the inequalities characteristic of the American economy. To the right of the third way is said to lie social disintegration, to the left, economic inefficiency. But does this third way exist? And if it does, how will we recognise it? Critics of the search argue that there is no third way: that it is impossible in the modern world to combine a dynamic economy with social stability – that there is an inevitable trade off between the two. I too am sceptical, but of the search, not the solution. I believe there is a third way, but I also believe it's more familiar than many recognise or are prepared to accept. The danger is that in the search for something new and different we overlook policies of proven effectiveness.

How the search started

The search for a new and distinctive approach to economic policy has its origins in a simple diagnosis of the source of the economic problems which face industrialised countries. Globalisation and changes in technology, it is argued, mean we live increasingly in a *winner takes all* world, where the gap between winners and losers in society is constantly widening. Economists have summarised this in the rather inelegant phrase *skill-biased change*. It is also argued that the economic problems take different forms in different countries. In the US and the UK, for instance, with their relatively limited welfare states and weak trade unions, there have been dramatic increases in wage inequality – to levels not seen since records began. Continental European countries have, by contrast, prevented this rise in wage inequality, but at the price of much higher unemployment. But these apparently contrasting changes are simply two sides of the same coin, two symptoms of the disease. If the diagnosis is correct, therefore, industrial economies have changed in a way which means the old fixes no longer work: new policies are needed for a new world, in other words, a third way.

But is it misguided?

The idea that economic forces are responsible for the widening gap between winners and losers is elegantly simple and thus appealing; and this argument has rapidly become conventional wisdom – especially amongst the winners. But it is mistaken to be seduced so easily: when examined more closely, the evidence in support of this view looks much less persuasive. If skill-biased change were the cause of the rise in unemployment in Europe, it would follow that this rise should be concentrated among the lower-skilled. Yet although the CEP has examined this phenomenon in several different ways, we have all reached the same broad conclusion: the rise in unemployment in continental Europe is more or less uniform across all skill groups. These countries show little evidence of a dramatic shift in favour of skilled workers. So what is happening in labour markets of OECD countries?

Unemployment has gone up...

The prevailing view among economists is that high unemployment in continental Europe is the result of deficiencies in the structure of these countries' labour markets. There is a consensus that reforms are needed; but a different view on what those reforms should be: a shift towards the Anglo-Saxon model; or the adoption of completely new policies – the third way. No one can deny the facts: the unemployment performance of the US is far superior to that of most of continental Europe (though it's by Alan Manning

worth remembering how recent the American advantage is – West German unemployment was below that of the US until the early 1990s). But there is an alternative, if rather more mundane, explanation for what has been happening to these economies. This is not that there has been a structural change requiring structural reform, but that high unemployment has resulted from the very tight macro-economic policies pursued to meet the targets for economic and monetary union. This is not an argument that gets much attention.

...but whose fault was it?

Europe's central bankers believe unemployment is largely a structural problem, that cutting interest rates to expand demand would quickly lead to rising wage inflation. They subscribe to the theory that monetary policy cannot, in the long run, affect the level of unemployment. This is not at all a surprising view for central bankers to hold. One might, however, think that governments committed to social cohesion might be less convinced by the structural diagnosis of unemployment. But European governments are completely hamstrung by their political commitment to monetary union. If high levels of unemployment aren't structural in origin, they must be the result of macroeconomic policies; but these policies are determined largely by the need to qualify for monetary union. To criticise them would be to jeopardise the project. And any attempt to persuade central bankers to mellow out a little is met with accusations of political interference and is said to augur badly for the future independence of the European Central Bank.

The end result of all this is that the central bankers' view – that unemployment is influenced by labour market institutions and nothing to do with them – has prevailed. The politicians may be privately unconvinced but they have little control over interest rates and dare not be seen to criticise central bankers overtly. So nothing happens: and there is now a real danger that continental Europe faces a prolonged period of stagnation. Perhaps the closest historical parallel is with Britain between the two world wars, when the return to the Gold Standard in 1925 at an absurdly high exchange rate consigned the UK to double-digit unemployment virtually until the Second World War.

But how to choose?

The sources of these higher levels of European unemployment are therefore crucial in deciding on the appropriate remedy. The problem is that the evidence is unclear. Consider the UK. It's clear that there have been major changes in the UK labour market since Mrs Thatcher came to power in 1979. Trade union influence has declined, welfare benefits have fallen relative to earnings, minimum wages have been abolished and marginal tax rates for high earners have been slashed. The result of these changes is seen most clearly in the enormous rise in wage inequality – to the highest levels since statistics were first collected more than a century ago.

If the source of Europe's unemployment woes is indeed overly tight macroeconomic policy, the search for the solution is somewhat less exciting.

Many economists claim that these labour market changes have also been responsible for the current relatively low level of UK unemployment. But this is far more difficult to demonstrate convincingly. It is impossible to detect any evidence of an improvement in performance until after 1993 – a period in which UK macroeconomic policy was expansionary following Britain's undignified exit from the exchange rate mechanism (ERM) in late 1992. After that event, sterling was devalued by around 15%, interest rates were gradually cut to their lowest level for 25 years and the government deficit peaked at around 8% of GDP. In macroeconomic policy terms, the foot was flat down on the accelerator and the ensuing fall in unemployment was hardly surprising. What is surprising – and significant – is that it has fallen so low without any resurgence in inflation.

As has already been noted, the other distinctive feature of both the UK and the US economies during the 1980s and 1990s is the extent to which inequality has risen. There has been an unprecedented redistribution from poor to rich (though this has slowed in recent years) largely justified in the name of progress: that this was an inevitable feature of changes in technology and the global economy that were propelling us towards the *winner takes all* society. There is probably some truth in this idea, although it is striking that it has been argued most strongly by those who have gained most from the changes which have taken place. But the extent to which these changes led to falls in unemployment is at least questionable: research in both countries, for instance, suggests that while changes in the level of minimum wage have quite large effects on redistribution, the impact on employment is quite small.

A history lesson

The post-war period was essentially one long boom in the industrial countries, during which incomes grew at an unprecedented rate and unemployment rates were at historically very low levels. Unemployment rates in the main European economies were below the level in the US – even though most of the structural differences in the labour markets already existed. Optimism that the secret of successful economic management had been discovered led to the continued expansion of the welfare state in many countries: it is relatively cheap to be generous to those without work when there are fewer of them. All this came to a halt with the very sharp rises in oil prices in the 1970s (though hindsight suggests that the boom had already become unsustainable). Unemployment rose sharply in all OECD countries.

Governments responded to the crisis in different ways, most seeing it as a temporary problem. Some tried to prevent the rise in unemployment by restricting the ability of employers to fire workers; others tried to ease the effects of unemployment by measures such as an extension of the period for which unemployment benefits were payable. But the results were much the same: by 1980, unemployment was around 10% both in the US and Europe. The main difference was that the more generous welfare systems in Europe meant that these levels of unemployment created much bigger problems for the public finances.

To the right of the third way is said to lie social disintegration, to the left, economic inefficiency. But does this third way exist? And if it does, how will we recognise it?

The 80s turning point

It was at this point that the experience began to diverge. Unemployment started to fall in the US in the early 1980s, but not in Europe. Institutions did matter: it was harder for the necessary adjustments to be made in European labour markets. Firms became cautious about hiring staff because of the difficulties involved in laying off workers. By the mid 1980s European unemployment finally began to fall. But this turned out to be a relatively short-lived trend – it was reversed in the late 1980s and the explanation of this reversal is crucial to the debate about the third way.

Those who take the structural view argue that the European recovery ended when wage inflation started to rise, providing evidence that the natural rate of European unemployment had shifted upwards. But critics of this view argue that the boom ended not in a burst of inflation but when the Bundesbank slammed on the brakes and raised interest rates in a response to German unification. Those European countries which were in the ERM had to follow suit and raise their interest as well or realign. The drive to economic and monetary union ruled out the latter option for most ERM members. The recovery therefore ground to a halt and those economies have stagnated as their central banks have continued to bear down on inflation.

The story for the UK is somewhat different, of course. Its 1980s boom ended in rapidly rising inflation at a time when unemployment was much higher than we see today. But there were other factors which account for this: the deregulation of the housing market and the associated explosion in house prices, and the weaker position of the pound all gave an extra boost to inflation.

Is macro policy the key?

If the source of Europe's unemployment woes is indeed overly tight macroeconomic policy, the search for the solution is somewhat less exciting. The solution is there: will it be implemented? It's clear that there can now be no relaxation of policy before monetary union starts; and once EMU has begun the new European Central Bank may be anxious to demonstrate its virility to the financial markets by maintaining a tight grip on inflation. There is no inevitable conflict between monetary union and low unemployment, but in current circumstances there may be. The decision by the Banque de France to raise interest rates last year was clearly not related to the needs of the French labour market.

In the US and the UK, untroubled by the commitment to monetary union, redistribution is a greater concern. For them, the third way involves not a radical new solution but a return to the path they have followed before – strengthening those institutions which reduce wage inequality. There are signs they may already be moving in this direction: the US has raised its minimum wage, the UK is about to introduce one. Tax reductions in future are likely to be concentrated on improving work incentives at the bottom end of the income distribution rather than at the top.

No third way but no complacency

None of this is meant to sound complacent. There are changes which need to be made to continental European labour markets, particularly in reversing some of the measures first adopted during the 1970s' oil price crises and some of the over-ambitious extensions to the welfare state and the collective bargaining systems introduced just prior to those crises. And the US and the UK should not return exactly to their old redistributive systems. Welfare states do need to change, perhaps more for social reasons (such as the increased involvement of women in the labour market and the rise in single parent families) than economic ones.

But I question the need for a radical new vision. European labour market institutions served us very well in the 1960s. They can do so again.

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New principles for government

In its first year in office, Britain's new Labour government introduced important reforms in the conduct of economic policy. Guest columnist Ed Balls, Economic Adviser to Chancellor Gordon Brown, explains the thinking behind the changes.

Transparency is at the heart of the new government's economic approach. Open and accountable institutions and procedures improve the information flows and promote public understanding and trust which are vital to ensuring stability. A lack of openness and transparency breeds instability and confusion. This is truer than ever in a world of global capital markets. The power of *the markets* is always and everywhere: dollar slumps on bad trade news, Deutschemark rises on good inflation news, or, as the Wall Street Journal once reported in its headline, *Dow-Jones falls on no news*.

Macroeconomic stability – low and stable inflation and sound public finances – is essential. It is a fundamental pre-condition to achieving the government's economic objectives – high and stable levels of growth and employment. But changes in both the world economy and our economic understanding of it over the past twenty years mean that policymakers must pursue stability through new means. Gone are the days of fixed policy rules announced in public and of private deliberations behind closed finance ministry doors, with little or no justification or explanation about policy decisions or mistakes.

New policymaker guidelines

In a world of global capital markets where policy through fixed rules announced in public and discussed in private has been discredited in theory and practice, governments must take a different route to ensuring macroeconomic credibility and stability. New principles must guide decision-making and institutional design:

- *stability through constrained discretion;*
- *credibility through sound, long-term policies;*
- *credibility through maximum transparency;*
- *the principle of trust through pre-commitment.*

Stability

The first principle embodies the pro-stability but post-monetarist intellectual consensus upon which modern macroeconomic policy-making is based. The pursuit of stability through adherence to fixed policy rules – the experience of the 1980s – is no longer common practice. Why? Because the world is too complex, with relationships previously considered stable breaking down. In a rules-based approach – where the goal is to stick to the policy rule – then one must stick to the rule. But if the aim of policy is to keep inflation low and stable, and growth as high and stable as possible, then sticking to policy rules (as a goal in itself) can lead to failure.

Hence the first principle – stability through constrained discretion: the acceptance of discretionary macroeconomic policy to respond flexibly to different economic shocks – constrained, of course, by the need to meet the low inflation objective or target over time. But if the need for discretion was so obvious, then why the attraction to fixed policy rules in the first place? Governments sought something more than simplicity – that extra something was *credibility*. Or to use economics jargon, to make policymaking *time consistent* by ensuring that a government actually has the incentives to achieve the future goals to which it has committed.

The old route to credibility was fixed policy rules. But fixed policy rules did not deliver credibility, far from it. Because the government had staked its credentials on following rules, it –

and the economy – was immediately faced with paying a heavy price for breaking them – not simply in lost output but also lost credibility. So what is the modern route to credibility which preserves discretion?

Credibility

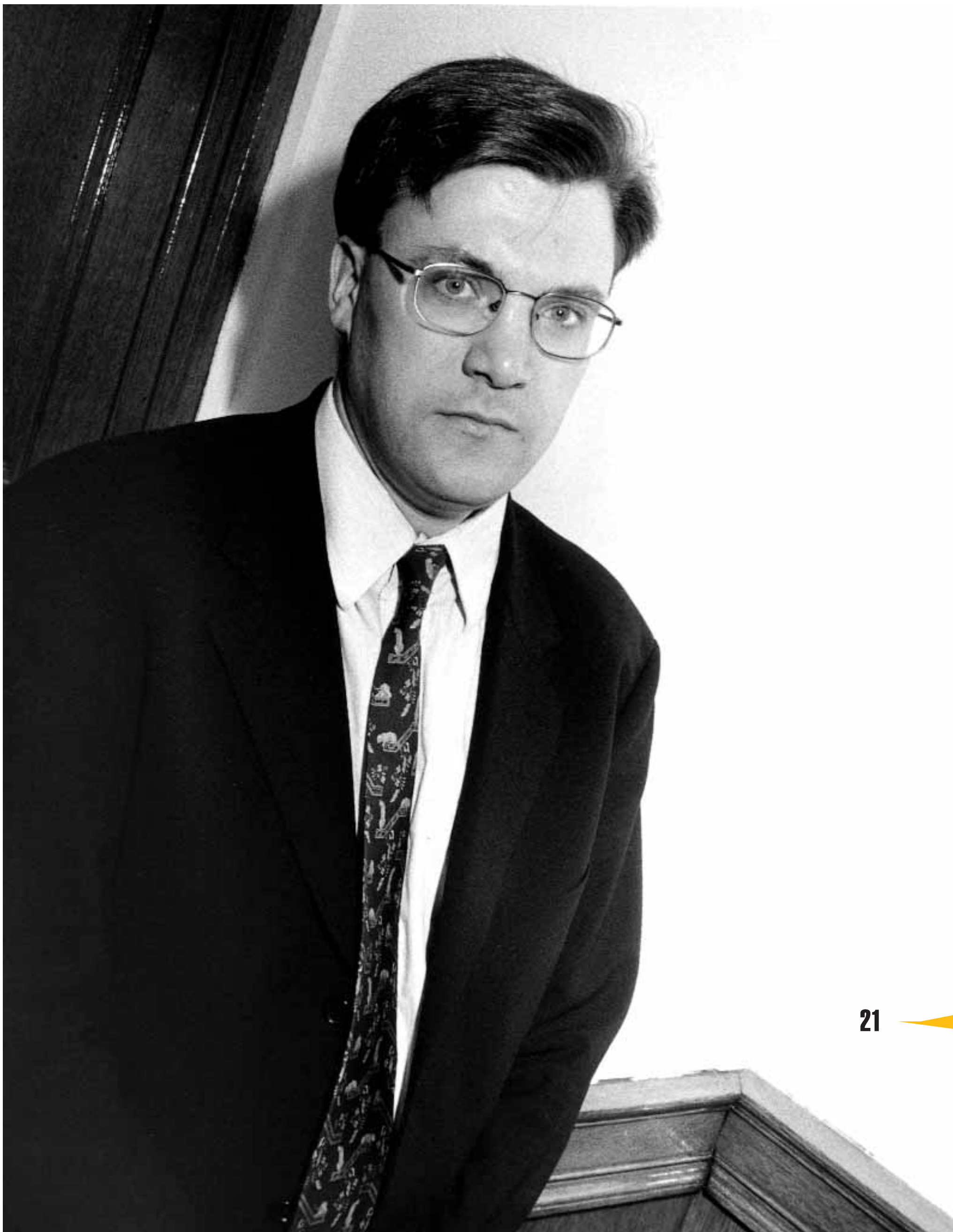
The rapid globalisation of the world economy has made achieving credibility more rather than less important, particularly for a new government with no track-record. This process of globalisation has many dimensions – technological change, capital market liberalisation and the growth and global reach of international trade. For macroeconomic policymaking the most significant change is the globalisation of international capital markets. But far from rendering governments impotent, global capital markets actually render governments more powerful in their ability to do bad or good – because the main dimensions on which they have now influence are scale and speed rather than direction.

Governments which pursue monetary and fiscal policies not seen to be sustainable in the long term, and, worse, attempt to conceal the fact through short-term diversion or deceit while delaying the necessary corrective action, are punished hard these days – and much more rapidly than thirty or forty years ago. Once such a mistake occurs, it can take a long time to repair the damage, in terms of lost credibility, and so rebuild the ability to deliver stability through discretion. Conversely, governments which pursue, and are judged by the markets to be pursuing, sound monetary and fiscal policies, can quickly attract significant inflows of investment capital. Furthermore, they can use discretionary monetary, or indeed fiscal, policy to deal with macroeconomic shocks which need to be accommodated in the short term.

So we reach the second principle – *credibility through sound long-term policies:* in a world of rapidly mobile capital, governments can have policy credibility *and* maintain policy discretion if they pursue, and are seen to be pursuing, monetary and fiscal policies which are well understood and sustainable over the long term and where problems are spotted and tackled promptly rather than disguised, while the government clings to intermediate indicators to prop up credibility.

The problem with this second principle is that, while a step in the right direction, it still rather begs the question of how credibility can be achieved and the *time inconsistency*

Gone are the days of fixed policy rules announced in public and of private deliberations behind closed finance ministry doors, with little or no justification or explanation about policy decisions or mistakes.



Clear principles, sound institutional reforms, and a genuine commitment to transparency and accountability, create the conditions for better policymaking.

problem solved, especially for a new government with no track record.

Maximum transparency

At the heart of the *time inconsistency* problem is imperfect information – about the true state of the macro-economy and, more importantly, about the true motivations of policymakers. Discretion for policymakers would be straightforward if it were always immediately clear what discretionary action was needed and why. But suspicion over motivation, and asymmetry of information between government and the public lead to heavy blows to credibility when things go wrong.

The greater the transparency about government objectives and the reasons why decisions are taken, the more information about outcomes that is published as a matter of routine, and the more checks on the ability of government to manipulate the flow of information, the less likely it is that investors will be suspicious of the government's intentions, the greater the flexibility of policy to react to real crises and the easier it is to build a consensus for difficult decisions.

This principle takes us part, but not all of the way, to credible discretion. It makes *cheating* on policy mistakes less likely and more costly – so helping to ease the time inconsistency problem. But alone it does not solve the problem.

Pre-commitment

We live in a dynamic world in which reputation matters. Government can get away with cheating once, but only at the cost of future reputation. Once cheated, the public and markets expect it again and again. Providing full information about the government's objectives and whether it is meeting them, makes failure to take a long-term view too costly to contemplate. But it is possible to go further still. Institutional mechanisms can be established which make clear that it is the government's intention to do the right thing – to make, in the jargon of game theory, a *strategic pre-commitment*. The more institutional arrangements can demonstrate that policy is truly trying to achieve its declared objectives, and the more difficult it is for the government to cheat by breaking promises or aiming for different objectives, the more the public and investors will believe that decisions are being taken for sound long-term reasons.

Principles into practice

Since coming into office, the government has put in place new monetary and fiscal policy frameworks which are informed by, and consistent with, these principles. In monetary policy the most important economic reform that the new government has introduced is operational independence for the Bank of England. Under legislation, the Bank is committed to setting monetary policy to achieve price stability as defined by the government's inflation target. This institutional reform pre-commits the government to a clear monetary policy of low inflation and, without prejudice to that, to support the objectives for growth and employment. This secondary objective is important because it makes clear that the Bank has (constrained) discretion to respond intelligently to supply-side shocks, using the *open letter* procedure.

These same principles have also been applied to fiscal policy, which is now set to achieve clear and unambiguous rules: the *Golden Rule* – to balance the current budget on average over the economic cycle – and to stabilise the ratio of debt-to-GDP at a stable and prudent level over the economic cycle. These are transparent and cannot easily be changed as the cycle progresses. Importantly, while the government has pre-committed to sound long-term fiscal policies, the discretion to use fiscal policy, if necessary, to respond to economic shocks has been preserved.

These policy changes have accompanied and underpinned institutional steps to increase policy credibility. The National Audit Office now considers the conventions used in Budget decision-making to ensure that sound, defensible, assumptions are used. The Pre-Budget Report process serves to open the Budget process and increase consultation.

Finally, the Code for Fiscal Stability enshrines openness and transparency in legislation. The Code requires the government to set fiscal policy objectives consistent with five principles of fiscal management: transparency, stability, responsibility, efficiency and fairness, and to report openly and regularly on performance against them.

So in fiscal policy, as in monetary policy, the new government acted early to boost its policy credibility. Discretion has been preserved. A sound long-term basis for policy, with clear targets, has been established. Policymaking is more transparent than in the past. Changes at the Bank of England, the Code for Fiscal Stability and the new role for the NAO, guarantee this long-term commitment to stability will be maintained.

Will this make for better policy? Only time will tell. Clear principles, sound institutional reforms, and a genuine commitment to transparency and accountability, create the conditions for better policymaking. But it is results that count. Outcomes speak louder than reforms.

Edward Balls is the Chancellor's Economic Adviser.

by Daniel Sturm

A lot of hot air?

The Kyoto deal and emissions trading

Negotiators are hard at work trying to turn the Kyoto Protocol agreed last December into an effective means for reducing greenhouse gas emissions and so halt the process of global warming. The central feature of the deal was the – controversial – introduction of a scheme for emissions trading. Daniel Sturm of the CEP assesses new evidence which the negotiators should draw on to make a global trading scheme a success.

Even by the standards of international summitry it was a nail-biting finish. Not until the final hours of the Kyoto Summit could anyone be certain that an agreement on greenhouse gas emissions would be reached. The arguments – especially between the industrial countries on the one hand and the developing countries on the other – were bitter. They were also plagued by confusion, particularly about the difference between the reducing *global* cost of cutting emissions and the way the burden of these costs were *shared*. Central to the dispute was American insistence that any deal to cut greenhouse gas emissions should be accompanied by a new scheme of global trading in emission permits.

The American view prevailed: the Kyoto deal made provision for a trading scheme central to the strategy for overall cuts in emissions. But ratification of the agreement by all the signatories is still some way off, and depends crucially on the creation of a workable scheme for emissions trading. The accumulating evidence about the extent to which such schemes have been successful in the US underlines the extent to which agreement in principle is only half the battle. It's the details of any scheme which can make or break it – and the Kyoto negotiators must ensure they learn the right lessons from past experience.

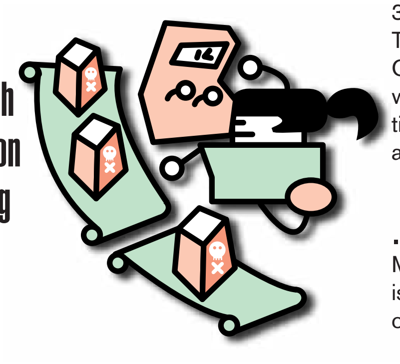
The problem's familiar...

The worries about the impact of global warming are all too familiar. The growing emission of greenhouse gases into the atmosphere concern scientists who fear that the subsequent build-up of these gases – of which carbon dioxide is the main one – will raise global temperatures significantly. *Emissions* themselves don't directly cause the problem, rather the *concentration* of gases in the atmosphere. Such concentrations have already increased by about 30% since the middle of the last century. The Intergovernmental Panel on Climate Change has predicted that if no action were taken to limit emissions, concentrations of carbon dioxide could increase by a further 6% by 2010.

...as is the solution

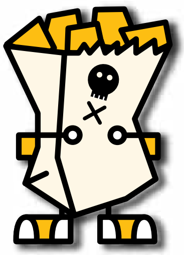
Much more difficult to predict, of course, is the impact of these expected climatic changes, and their economic conse-

Economists, however, have long advocated a market-based approach to pollution control: so that emission reductions are achieved by altering the price incentives polluters face rather than by direct regulation.



quences. Such uncertainties have been seized on by those resistant to the need for big global reductions in greenhouse gas emissions. But contrary to the perception of some people, this was not the source of the disagreements at Kyoto. Indeed, the Protocol signed last December has been seen as an important step in creating a global response to the problems of climate change. The industrial countries and those economies classed as being in transition have accepted a legally binding commitment to reduce their emissions by about 5% from 1990 levels by the period 2008-2012. (The Protocol places no limits on emissions from developing countries.) These new limits on emissions are expected to have a small but significant impact on concentrations by 2010.

Greenhouse gases inflict the same global damage no matter where on the planet they were originally released.

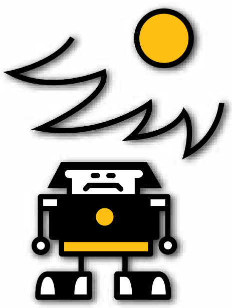


Although it's the concentration levels which matter in climatic terms, emission levels are the means by which these can be controlled in future; and controlling emissions is hugely expensive. Estimates of the annual cost simply of stabilising emissions at 1990 levels currently range from 0.4% to 1.3% of world GDP in 2010. The search is therefore on for ways to limit these costs. Kyoto broke new ground in this search by introducing provisions for trading in emission rights. Indeed, these provisions are crucial to the success of the deal: not only should they help reduce the cost of emission controls, but the United States has refused to ratify the Kyoto Protocol without a satisfactory trading scheme.

The economic rationale

Environmental policymaking in the past has been dominated by the *command and control* approach: this has specified either the control technologies to be used or set the emission limits to be attained for specific pollution sources. Economists, however, have long advocated a *market-based* approach to pollution control: so that emission reductions are achieved by altering the price incentives polluters face rather than by direct regulation. Tradeable emission permits are a good example of this market-based approach.

The growing emission of greenhouse gases into the atmosphere concern scientists who fear that the subsequent build-up of these gases – of which carbon dioxide is the main one – will raise global temperatures significantly.



The basic structure of such a scheme is simple enough. The first step is to agree on the total reduction in emissions (5% for the countries covered by the Kyoto Protocol). Then the total amount of emissions permitted after the reductions have been made is divided up into allowances – for example, one allowance might mean a permit to emit say one tonne of CO_2 each year. These allowances are then shared out among the participants of the scheme, according to a pre-arranged formula. The idea is that these allowances, or permits, can be traded on a market: essentially allowing permits to pollute to be bought and sold. Then at the end of each year, an independent regulator compares the actual emissions of each polluter with the size of the allowances held. Any individual, company or country which generates more emissions than their permits entitle them to will be penalised, just as they would under the traditional regulatory approach.

But why would such a scheme be expected to reduce the cost of implementing overall reductions in emissions? The answer lies in the fact that the costs of reducing emissions is likely to vary across companies and countries. If everyone had to reduce their total emissions by a certain amount some would find it easy and therefore cheap to meet the target; others would find it very expensive indeed. Trading permits for emissions enables parties with very different costs to engage in a mutually beneficial exchange. Those with low costs will find it attractive to reduce their emissions even further than the target reduction and then profit from the sale of the excess permits they don't need. But those for whom any emissions reduction would be expensive could find it cheaper to buy someone else's permits instead.

Provided the transactions costs of this trade in emission permits is kept small, the result will be that emission reductions are made wherever it's cheapest to do so. Eventually trading will equalise the marginal cost of emission reductions for everyone and so ensure that the global costs are kept to the minimum.

But these benefits are likely, if anything, to understate the cost savings to be had from emission trading. Consider a polluter who is forced to use a specific pollution control technology. He has clearly little incentive to find new and cheaper ways of controlling pollution. But under a tradeable permit scheme, each polluter would be free to choose any means of keeping emissions in line with the permits held. There is then an incentive to cut the cost of reducing emissions, because that would then provide the opportunity to sell unused permits on the market.

The equitable distribution of the burden of reducing greenhouse gas emissions is an important and a contentious issue.

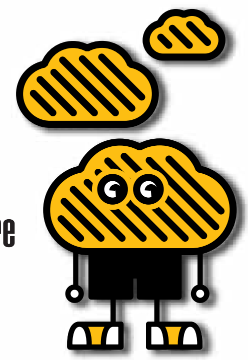
Attempts have been made to quantify these potential savings. In 1995 the Intergovernmental Panel on Climate Change examined models which try to simulate the savings from a trading scheme compared with a system of uniform reductions in emissions across countries. Such models don't take account of the benefits from technological innovation which might flow from a tradable scheme. And the Panel found huge variations in the estimates of savings to be had: from 10% to 50% of the total cost of making emission reductions. But it's significant that *all* the current models agree that there would be savings under such a scheme. It's also worth remembering that given the scale of the costs involved, even a 10% reduction amounts to a huge amount of money.

Moreover, all these savings can be achieved without any reduction in the environmental benefits to be gained from emission reduction. Greenhouse gases inflict the same global damage no matter where on the planet they were originally released. Changes in the way emission reductions are made – cutting them in one part of the world, raising them in another – can have no negative impact on climate change.

But is it fair?

It's the arguments about *equity* that have muddled the debate about emissions trading. Critics argue that it lets the industrial countries, and in particular the United States, buy their way out of their responsibility to reduce emissions. It's clear from the nature of the discussions

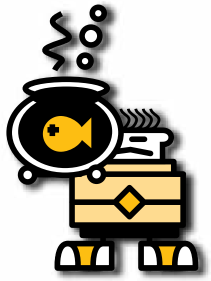
The purpose of emissions trading is to keep the global costs of reducing emissions as low as possible; such schemes are not about how the burden of reduction is shared.



both in Rio and Kyoto that the equitable distribution of the burden of reducing greenhouse gas emissions is an important and a contentious issue. The Rio Convention of 1992 incorporates the now famous principle that all countries have a *common but differentiated* responsibility for protection of the climate system.

The concept of equity is important because of the huge discrepancies in greenhouse gas emissions between the industrial and the developing countries. In 1990, the US alone accounted for about 35% of total CO_2 emissions, and the European Union countries for another 23%. Emissions per head show an even starker contrast with the developing countries: in the latter, CO_2 emissions currently average 0.5 tonnes a year, compared with an average of 3 tonnes a year in the industrial world. Many people, and especially those in the developing countries, argue that these figures make it imperative for the industrial countries to take the lead in reducing emissions.

This is where the confusion is at its greatest. The purpose of emissions trading is to keep the *global* costs of reducing emissions as low as possible; such schemes are not about how the burden of reduction is shared. It's the initial



All the current models agree that there would be savings under such a scheme.

distribution of allowances which determines how such responsibility is divided up. Giving a larger allocation of permits to developing countries, for instance, would raise the cost of emission reductions to industrial countries because they would end up having to buy more emission permits on the market. By doing so, they would shoulder more of the financial burden of emission reduction, while trading ensures that emissions are reduced wherever this can be done most cheaply.

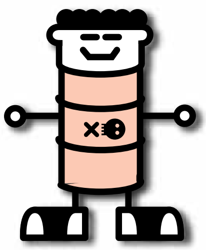
Putting theory into practice

The negotiators now drawing up a trading scheme know how much is riding on the plan they come up with. New data on the way such schemes have been operating offer important indicators for developing a successful scheme. Virtually all such schemes are in the US, where experience shows that the details can make the difference between success and complete failure.

In the early seventies the very first trading provisions were introduced into the American Clean Air Act, which covers several pollutants, including sulphur dioxide, nitrous oxide and lead. This early trading differed substantially from a full-blown trading scheme. Trade had to be approved on a case-by-case basis with expensive approval procedures that could take up to two years. The performance of the market was very disappointing with much fewer transactions taking place then expected. Although annual cost savings were estimated at anywhere between $100m and $1400m this represented only a small percentage of total expenditure on air pollution control. Most observers agree that the central problem was the enormous complexity of the original regulations – these just prevented many cost saving trades from taking place.

In 1990 the trading provisions were fundamentally reformed. A market close to the textbook ideal was introduced to combat acid raid from sulphur dioxide emissions. The scheme, which is still the largest pollution market, in operation, is targeted at the electric utilities which account for over two thirds of total sulphur dioxide emissions. By 2000, the aim is to reduce emissions by a very ambitious 50% compared with 1980 levels. There is minimal interference with permit trading, with the role of the regulator limited to recording transfers and determining compliance at the end of each year.

The key lesson that emerges from the American experience is overwhelming: keeping transaction costs low is much the most important requirement for a successful trading scheme.



After a cautious start to trading in 1993, activity under this programme has picked up remarkably, with trades doubling on average every year since 1993. With such large trading volumes the market is expected to generate savings of around 50% compared with the traditional approach to emission reductions. The US General Accounting Office is now projecting savings of around $3 billion annually by 2000. Compare this with a different scheme, to reduce pollution from pulp manufacturers in the Fox River. This could bring savings of around $7 billion, said the scheme's architects. In fact, the rules were so complex, that only one trade was ever recorded.

Transaction costs are what really matter

The key lesson that emerges from the American experience is overwhelming: keeping transaction costs low is much the most important requirement for a successful trading scheme. If the rules aren't as simple as possible, most of the incentives for engaging in trading will be removed – and at least a significant portion of trades won't take place. The Kyoto Protocol is worryingly unclear in this area. Of the provisions that deal with trading among the industrial countries, one seems to envisage a case-by-case approach similar to the original US scheme, along with the complicated rules likely to deter trading. But other parts of the Protocol seem to envisage a scheme on the lines of that operating successfully in the American sulphur dioxide market. Which of these options is pursued further will be crucial in determining whether or not a greenhouse gas trading scheme is successful.

Since developing countries have no emission limits set under the Kyoto agreement, trading between them and the industrial countries will have to be on a case-by-case basis. The Protocol provides for the industrial countries to acquire extra emission permits by financing projects to reduce emissions in developing countries below what they would otherwise have been. This last definition is, of course, highly contentious in the absence of agreed emission limits for the developing world. Nevertheless, transparent and simple rules will be crucial if excessive transaction costs are to be avoided, and trading encouraged.

The jury's still out

It's an old cliche to say that the devil is in the detail. In this case, however, it's true. Much of this detail will be high on the agenda of the next meeting of the parties to the Protocol in Buenos Aires in November this year. The Kyoto Protocol does offer the prospect of a workable deal on controlling greenhouse gas emissions. Limiting rather than halting the build-up of greenhouse gases may seem a modest achievement, but it's one which seemed likely to prove elusive a year ago. The negotiators know they still have a long way to go.

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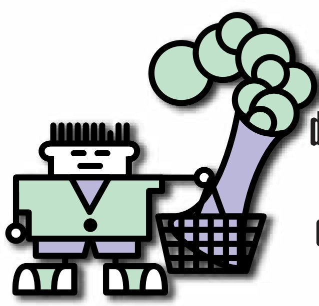

The Kyoto Protocol does offer the prospect of a workable deal on controlling greenhouse gas emissions.

Trains, planes and technological advances...

The weightless economy should be viewed as the logical next stage in economic development, writes Danny Tyson Quah in his return to the weightless economy column.

weightless economy

Danny Tyson Quah

When economists invented growth accounting in the late 1950s, they found that technical change accounted for almost 90% of US economic growth in the first half of the 20th century. Accumulation of physical capital-investment in machines, construction, heavy metal explained less than one-eighth of the four-fold increase in prosperity of then-recorded history's most dynamic economy.

Technical change...

Two things are remarkable about this. First, that period in the history of economic thought is supposed to be dominated by economic theorists obsessed with Soviet-style accumulation of factor inputs as the route to economic success. Wrong. Academic literature of the early twentieth century shows a profound interest in understanding the sources and implications of technical change. The literature might not have got very far, but the supposedly modern concerns were already there.

Second, the US economy, in real life, was then no playground of rocket science. It was not chock-full of nifty technological whizz-bang gizmos, the way the Western world is today. It was not moved by the learned debate of scientific societies and the ferment of intellectual excitement and engineering discovery the way that, say, England was during the Industrial Revolution, with James Watt and Matthew Boulton's race against time at the patents office, or the intellectual and political battles between Charles Babbage and George Airy on, not just the *content* but the *practice* of good science.

Telephones

For communications, the telegraph and telephone were technologies

Mass production of Henry Ford's Model 'T' went online by 1908; the car would be sold, unchanged for two decades in design and implementation.

well in place by the beginning of the 20th century. An earlier time, the 1840s, comprised the period of greatest telegraph expansion, with intense rivalry between competing companies in the US resulting in the 1856 formation of the Western Union Company. By 1866, a permanent telegraph cable linked Britain and the US; by 1872, all the major cities in the world were similarly connected. Alexander Graham Bell's patent for the telephone was filed in 1876. The first telephone exchange appeared in Britain in 1879, removing telephony from the deathtrap of dedicated, fixed-line connections. Telegraph and telephony might well be viewed as prime technical drivers for the early 20th century; the truth is, these technologies were already well-established, and no technical change in them was new by the time period studied intensely in early growth accounting. What technical progress between 1900 and 1950?

Trains...

Take another example. By the beginning of the 20th century US rail track coverage had already exploded from less than 10,000 miles in 1850 to 20 times that by 1900. No grand technological vision or a deep insight about the world or profound scientific breakthrough propelled the success that would come in the half-century afterwards. By 1900 railroads were a technology well understood: in Britain passenger traffic was providing two-thirds of railway earnings by the 1840s. US railroad superiority over Britain and Europe had to do less with sweeping vision than with details like whether to prefer huge freight cars with double bogies and automatic central couplers over smaller four-wheeled wagons that used screw-couplings and side-buffers: hardly the burning issue to give sleepness nights to academics and government policymakers who can be fretting instead over education and the global information infrastructure. Mass production of Henry Ford's Model 'T' went online by 1908; the car would be sold, unchanged for two decades in design and implementation, to over 15 million customers. Where was the technical change explaining that 90% of economic growth?

And it isn't just the early part of the 20th century that technology seemed to move at glacial pace. Even in the white heat of the Industrial Revolution in the 18th century, fifty years after its initial colliery installation, the Newcomen steam engine still operated only at 1% fuel efficiency. It was about that same length of time before James Watt's condenser improvement allowed keeping the cylinder of the steam engine hot all the time, instead of the stressful, inefficient cooling and reheating between each power stroke. That's two human generations, or the time for a 10 billion-fold increase in modern computing power.

...and planes

To be sure, not everything points so clearly to the first half of the 20th century being a dull period of technological stagnation. Orville and Wilbur Wright's flying machine only went airborne in 1903, and airplane technology developed from then. But commercial aircraft, like the space-age technologies coming out of the Second World War atomic and nuclear energy, mainframe computers, television only really affected ordinary people's lives later, after 1950.

No, for the technologists among us (say, those who pore over the new electronic devices streaming out of Microsoft, Intel, Netscape, or Sony, and appearing on the World Wide Web every month), the US in the early 20th century for all its frenetic dynamic growth and its global technological leadership would have been boring beyond belief. But in spite of this, almost all US economic success then was due to technical change.

Now weightlessness

Of course, those familiar with recent research on total factor productivity might challenge my holding firm to Robert Solow's 1957 estimate of 87.5% for technology's contribution to early 20th century US economic growth. But that discussion will have to wait for a future column. I am concerned here with why the weightless economy should be viewed as the logical next stage if it's not already here in this economic development, and why society's response to it matters.

One of the most visible manifestations of modern technical progress is information and communications technology (ICT), a large part of the weightless economy. The real price of computing has been falling by 30% per year for the last two decades, a halving every two to three years. Communications too has seen its real price decline, although only by a relatively modest (but still spectacular) 8% per year for the last 70 years. Technical progress at this rate is unprecedented. How much more it must now be contributing to long-run economic growth. History records few other instances of similarly large, extended changes in the relative price of goods so intensely used by businesses and consumers.

This last is key: ICT and other elements of the weightless economy are now actually employed and demanded by significant portions of society.

Similarly, the rampaging supply of technology during the Industrial Revolution in the West was matched by a voracious appetite in technology's users, either by other suppliers or by final consumers themselves. Supply alone, no matter how hi-tech and chockfull of good ideas takes society nowhere, if unmatched by demand.

Lessons from China?

The saddest example of this one with lessons perhaps for those fearful of

The Chinese state committed what, with hindsight, we now know to be an egregious sequence of mistakes. In China, most technological development was in the hands of the government bureaucratic elite.

technology in the new weightless economy is the utter failure of the Industrial Revolution to take off in ancient China, where all technological prerequisites were already present long before the late 18th century. Everything petered out. Why?

In information processing, China had the putative headstart. It introduced paper 1,000 years before the West, and printing about 700AD. Chinese water clocks of 1086AD were more accurate than contemporaneous European mechanical ones. For transforming the material world around them, the Chinese were casting iron in blast furnaces by 200BC, centuries earlier than in Europe; spinning wheels for textiles and water power were developed at about the same time as in the West. The Chinese invented gunpowder: that they made only fireworks from it, not weapons for killing is to their credit, not as Rousseau said and many commonly think, a sign of backwardness.

Or maybe not!

Yet, in the presence of all these technological prerequisites, China did not experience an Industrial Revolution to set the world afire. It was ahead of the world in 1300; it was far behind by 1900.

Why? The supply side of technology was present; the demand side was not. The Chinese state committed what, with hindsight, we now know to be an egregious sequence of mistakes. In China, most technological development was in the hands of the government bureaucratic elite. New technology was controlled and not permitted to be widely used by the population. Indeed, the state saw a subversion of its power as the most likely outcome should the populace learn of and articulate a demand for the new technology. No diffusion of ideas and tools took place, and the Industrial Revolution that might have been instead died.

What does this have to do with the weightless economy? The easy interpretation is that the weightless economy is the for-now culmination of technological development. Whether society embraces its fruits and, through the usual workings of the marketplace, goes on to encourage further its development matters a great deal.

It will determine whether the 21st century mirrors the Europe of the Industrial Revolution or 14th century China

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Honey, I shrunk the government

Globalisation is a hot topic. But have governments thought about what the implications for them might be? Graham Ingham, editor of CentrePiece, asks the question.

It's no big secret that the world is changing – fast. Indeed, it's fashionable to argue that the pace of change is accelerating all the time. Much effort – in the pages of CentrePiece and elsewhere – goes into analysing the nature of change. But it is not clear that the implications of many global economic shifts are always fully understood. This seems particularly true in the area of public policy – where governments themselves often fail to grasp the full significance of what is happening – or at least do so only belatedly.

Economic policy tends still to be seen as something governments determine, and can see through. They like to take credit when things go right and for that reason, in democracies at any rate, they still tend to get the blame when things go wrong. Governments in office during periods of economic growth, for instance, stand a better chance of re-election than those who preside over economic downturns and rising unemployment. Governments actively encourage voters to believe which party is in power can make a difference.

But can governments really have so much impact? Is this really how the world still works, or have things moved on? Several of the pieces in this issue give at least a hint of the extent to which the role of governments in global economic life may be changing – whether they like it or not.

Money – a globalising force

Hélène Rey rightly talks about the competition for international monetary influence likely to develop once the European single currency, the euro, comes into being next January. The euro will provide the first real challenge to dollar supremacy since the Second World War: it will alter the balance of power within the international monetary system.
But while there are clear political advantages for the government whose currency is dominant in global terms, there are disadvantages as well. That's partly why in the past some governments, such as successive German and Japanese administrations, have sought deliberately to avoid reserve currency status.

According to the Rey analysis, however, this low-key approach may not be an option for the governments of the euro zone countries. The central thrust of her approach is the determining role of the foreign exchange markets. To a much greater degree than in the past it is these markets which will decide how and to what extent the balance of international monetary power shifts. They will do this quite simply – by the extent to which they use each currency. The deregulation of the international financial markets, coupled with the technology which makes the virtually immediate transfer of huge sums across the exchanges both possible and commonplace, gives these markets enormous power. It is perhaps ironic that just as the dollar's dominance looks as if it may be threatened the political benefits which have traditionally accompanied reserve currency status may themselves be diminishing because of the growing power of markets over governments.

Some governments have already had first-hand experience of the extent to which domestic policy objectives can be thwarted by the international financial markets. The British government discovered how painful this can be when sterling was forced out of the exchange rate mechanism of the European monetary system in 1992. Several governments in South East Asia have a much greater understanding of international market power than they did a year ago. In some cases these are governments who have hitherto benefited from the growth of international trade and international financial dealings. They now know such openness comes at a price – not being able to do whatever you want without regard to the rest of the world.

Good news for the criminals?

It's not just in the sphere of economic policy that the globalisation of money has interfered with governments' ability to plough their chosen furrow. A United Nations report on drugs, crime and money-laundering published in June illustrates the extent to which international financial deregulation has permitted the introduction of money-laundering – especially of drug-crime profits. About $300 million of foreign exchange transactions are reckoned to be illegal in origin. But it's extremely difficult to identify such cash, and its owners, once it is in the system. International cooperation among national governments is one way to tackle such drug-related crime. But this can only have a real chance of being effective if every country joins in. While some states remain, for whatever reason, outside the loop, ready to accept anonymous bank deposits, no questions asked, international cooperation can at best be a damage-limitation exercise, leaving participating governments frustrated and conscious of the limitations of power.

The physical source of illegally acquired money is as irrelevant to its owners as the physical location of the bank deposit. Such deposits are essentially computer transactions these days – no physical transfer of banknotes is involved (except, perhaps, at the initial stage when crime proceeds make their way to the bank). Laundering the profits of crime isn't the only activity which is no longer location-dependent, as Danny Quah is quick to remind us. Physical geography is ceasing to be important for an increasing range of economic and commercial activity.

But governments are constrained

Of course, in the short term at least, the decision to give more power to markets ensures that governments retain a role in the location and development of such activity. But this role is arguably a passive one: governments cannot force individuals or companies to set up and conduct business within their territory, they can only prevent them from doing so by draconian regulations. Even that power is being infringed. The development of satellite and information technology makes it increasingly difficult to prevent commercial activity. How can a government stop its citizens buying goods or services from a supplier on the other side of the world, short of cutting off telecommunications and postal services to its residents?

Elsewhere in these pages, Daniel Sturm raises some of these issues in a somewhat different context. It is, after all, not governments or states which actually pollute the atmosphere but individuals and firms in the private or public sectors within those states. The Kyoto proposal to implement a scheme for trading in permits to pollute will mean that governments themselves have little control over where such pollution takes place. The incentive structure of a trading scheme is intended to ensure that the cost of halting or reducing greenhouse gas emissions is kept to a global minimum – so that the actual reductions take place where they can be implemented most cheaply. This is a significant shift from the traditional approach which governments used to adopt – imposing specific reductions in each country.

No need to exaggerate

It is, of course, an oversimplification to suggest that governments have lost all their real power. They still have a major role, an ability to affect the everyday lives of their citizens and, in some cases, the citizens of other states. It is anyway a mistake to believe that governments, in the twentieth century at least, were always in control of their destinies; they have often been forced to react to external events outside their control.

Many of the changes now taking place in the world economy were initiated and have been encouraged by some of those states and governments now finding themselves most affected, often uncomfortably so. These changes do seem to imply that governments will have to rethink the way they interact with each other, their citizens and, above all, the international markets, physical, electronic and virtual. It's become common in the past twenty years or so to hear governments and economists talk about the adjustment process which usually means the process of economies adjusting to low inflation, a process which is painful for many individuals. It may now be the turn of governments to experience another kind of adjustment process – that of understanding the limits to their powers – and the best way to exploit those powers which remain.

Graham Ingham, Editor of CentrePiece, was formerly Economics Correspondent for BBC Television.

An end of term report

Continued from page 15

The best overall measure of productivity performance is total factor productivity growth. In spite of the difficulties of measurement, on this basis there is some reason to think that there have been lasting improvements. In the period 1960-73 the UK was in eleventh place on this measure; in 1979-95 it had moved up to fifth place. This offers some reason to hope that Britain's economic decline relative to other European countries may have been halted, or even reversed: though it would be easier to be sure of this if service sector performance had improved as much as manufacturing during the Thatcher years.

...and unemployment?

The test here is whether the Conservatives managed to reduce the NAIRU, essentially the equilibrium level of unemployment in the economy. Here too the record seems to be mixed – in political terms, of course, it was often seen as one of their greatest failures, but in economic terms the picture is significantly less clearcut. Changes to collective bargaining and the industrial relations structure do seem to have had a significant impact, especially for the long run. There is also evidence that the UK has improved its position relative to other industrial countries. Restraint on public spending helped, too: in the early 1990s, current spending was around 12% lower in the UK than the average of Western European countries – with unemployment around 2 percentage points lower than it might otherwise have been.

Of course, there were weaknesses in the strategy adopted. The most obvious was the failure to limit the duration of unemployment benefits, prior to the introduction of the Jobseekers Allowance in 1996 – the econometric evidence available suggests this was an important omission. And the National Curriculum did not seem by 1995 to have reduced the problem of low British attainment at the bottom end of the education system – especially as far as mathematics is concerned.

Yet given the legacy of 1979 in terms of industrial relations, inefficient use of labour and low skills, coupled with the political difficulty of labour market reform, unemployment might have been a good deal worse than it turned out to be. The Conservatives deserve more credit that they are usually allowed for averting that outcome.

The overall score

The long period of Conservative government left long-term growth prospects better than would have seemed possible in 1979; combined with a slowdown in competitor countries, this may permit the reversal of relative economic decline in Britain vis-à-vis Europe. The relatively low level of equilibrium unemployment in Britain can also be seen as a success for Conservative supply-side policies, although continuing weaknesses in education and training have led to the less attractive consequence of rising wage inequalities. Ironically, in view of their pronouncements in 1979, macroeconomic management was the Conservatives' Achilles heel, with major errors responsible for excessive economic fluctuations and the eventual loss of the government's reputation for economic competence; at the same time, the record on inflation compares unfavourably with that of other OECD countries.

While most of the governments' macroeconomic gambles failed miserably, microeconomic radicalism paid off handsomely – privatisation, industrial relations reform and the move away from the European tendency for excessive government budgets. Even here, though, opportunities to push this agenda more fully were missed, notably in the areas of welfare and tax reforms. The Conservatives' short-term agenda was frequently only too apparent.

Lessons for New Labour?

If macroeconomic outcomes are the criteria by which the success of economic policies are to be judged, the old Labour approach, both in and out of government, was seriously mistaken in many areas. The attachment to state ownership, protectionism, high taxation, subsidies for physical investment and Keynesian demand management, coupled with an unwillingness to accept reforms to industrial relations and welfare benefits were unfortunate, as Tony Blair and his New Labour colleagues have readily accepted. But has the new government learnt the right lessons from the Conservatives' experience?

In several important aspects, actions and rhetoric so far suggest that the answer is yes. The establishment of an independent central bank, the lack of interest in reversing privatisation, and continued restraint on public expenditure are all evidence for this. The announced intention to raise standards in education in bad state schools and to promote the fundamental welfare reform are encouraging: but the Conservatives discovered for themselves how difficult such objectives were to achieve in practice.

There are some signs that New Labour have not fully grasped the central role of incentives in improving economic performance. But with its large majority and the implicit acceptance that most of the supply-side reforms of the Conservative reforms were right, the new government could have the chance both to complete unfinished Tory business and raise the long-term growth rate of the UK economy.

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This is an edited version of the 1997 Wincott Lecture.

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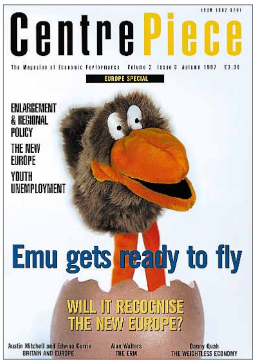

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